

1 DAUFUSKIE ISLAND UTILITY COMPANY, INC.

2 DOCKET NO. 2011-229-W/S

3 Rebuttal Testimony of John F. Guastella

4 Before the South Carolina Public Service Commission

5 Testimony Prepared: May 15, 2012

6 Hearing Date: May 30, 2012

7

8 **Q. Have you examined the testimonies and exhibits of Ms. Christine Stutz, Mr.**
9 **Willie J. Morgan and Dr. Douglas H. Carlisle that were filed on behalf of the**
10 **Office of Regulatory Staff (“ORS”)?**

11 **A. Yes.**

12

13 **Q. Do you have any general comments with respect to your rebuttal testimony**
14 **regarding the ORS witnesses?**

15 **A. Yes.** While I do not have a concern or objection as to some of the rate setting
16 adjustments and reconciliations of the ORS witnesses, the basis for some of the
17 adjustments and recommendations, departs from the required goal of establishing
18 rates that truly reflect the cost of providing safe and adequate service. In
19 establishing rates for DIUC it is important to recognize that DIUC is a very small
20 water and sewer utility, with a relatively small number of customers over which to
21 spread costs. DIUC’s location on an island adds to a greater level of costs to both
22 its operations and capital requirements. The former Haig Point Utility Company
23 (“HPUC”) and Melrose Utility Company (“MUC”) were created in connection

1 with real estate developments. On the basis of my previous consulting work on
2 behalf of HPUC, I know that its stockholder, International Paper (“IP”) did not
3 have management personnel with specific utility regulatory experience, and the
4 utility operation was not a significant focus of its interests in relation to its other
5 business activities. The transition from IP to CK Materials ownership has
6 required extensive work in establishing records and billing.

7 With respect to MUC, within a couple of months after we began managing
8 DIUC, I found that MUC had not been paying its 40% share of the joint venture
9 Haig Point/Melrose Wastewater Treatment Plant. As I discussed in my direct
10 testimony the loss of about 25-30% of our annual revenues created a serious cash
11 flow problem. After MUC’s bankruptcy and merger into DIUC, there were no
12 books and records, but fortunately the billing company MUC had been using was
13 the same as DIUC’s.

14 My next general comments is to make clear and unequivocal that the
15 highest priority goal of stockholders of CK Materials and I is to make absolutely
16 sure that DIUC is financially capable of providing safe and adequate service to
17 our customers. The surest way to do that is to establish the actual cost of
18 providing service – an actual cost of that is consistent with the Supreme Court
19 guidepost decision in Florida Power Commission v. the Hope Natural Gas, Co.,
20 U.S. 591 (1944), that there be enough revenue to cover the operating and capital
21 costs of the utility.

22 My last general comment is that we are very much aware of the
23 customers’ expressed concerns about the magnitude of the proposed rate increase.

1 We also appreciate the ORS's and PSC's responsibility to make sure that the rates
2 are reasonable and necessary for DIUC to provide adequate service. The PSC's
3 current rate setting policy that does not permit projected test years or allow capital
4 improvements that are not in service presents an almost insurmountable problem
5 for a small water and wastewater utility. As is typical, lending institutions will
6 not provide debt financing to a small utility unless it can demonstrate adequate
7 earnings that will cover the new debt service. This reality is the specific situation
8 we have experienced in my trying to obtain either short or long term debt for
9 DIUC's rate increase must reflect if it is to continue to provide adequate service.

10

11 **Q. Do you agree with the adjustments value by the ORS?**

12 A. As time permits, we will request ORS to provide more detail as to many of its
13 adjustments to both the original cost of utility plant in service and operating
14 expenses. We disagree with adjustments made by Ms. Stutz that a booked a cost
15 should be eliminated merely because it is "undocumented" or an invoice for it
16 cannot be found. For example, the cost of utility plant added subsequent to
17 HPUC and MUC last rate cases and before acquisition by CK Materials in July,
18 2008 and March, 2010, respectively, was booked and/or recorded in reports to the
19 PSC. There is no question that facilities exist and are used and useful, and clearly
20 there was a cost incurred for their installation. The absence of invoices does not
21 establish that there was no cost, or no cost should be allowed for rate setting. It
22 has been my experience that the predominant rate setting treatment if there is no

1 invoice or records is to determine whether the booked cost is reasonable – by
2 performing original cost estimates.

3

4 **Q. Do you agree with the adjustment to eliminate the cost of the elevated storage**
5 **tank in the amount of \$863,379 because of the land at the site was sold at a**
6 **tax sale?**

7 A. No. We were not average of the tax sale because Beaufort County sent bills to the
8 wrong addresses, but had been informed of our address after acquisition by CK
9 Materials. Beaufort County also did not post notices of the pending sale of the
10 site, as required. We have taken steps to reverse the sale. In any event, there is
11 absolutely no possibility that the Storage Tank will not continue to be used to
12 provide water service – this is known as a certainly and the cost of the tank is
13 known and measurable. Disallowing the cost of this tank is unreasonable.

14

15 **Q. Do you agree with the elimination of the cost of land?**

16 A. No. The failure of previous owners to maintain the records as to the cost of land
17 does not preclude a recognition of an estimated cost. The land exists and it is
18 used and useful, and it is subject to property tax.

19

20 **Q. Would you comment about the adjustments Ms. Stutz has proposed to the**
21 **operating expenses?**

22 A. Yes. Without addressing each adjustment separately, I disagree with those
23 adjustments that were made due to lack of documentation if the expenses were

1 obviously incurred in serving the customers. I also disagree with adjustments that
2 were made because they are not known and measurable where the reason for that
3 position is the expense has not yet been paid. For example, we have submitted an
4 application for insurance with Grundy Agency and reflect the estimated cost in
5 DIUC's revenue requirement. Ms. Stutz disallowed the expense because the
6 amount has not been paid yet. "Known and measurable" should not be restricted
7 to only costs that have been paid. There is no question that we will obtain
8 insurance and the cost is measured on the basis of an estimate.

9 Another example is Ms. Stutz disallowance of the cost and expense related
10 to a new billing system. There is a need to switch to a billing system that will be
11 an improvement over the existing system that was carried over from previous
12 ownership. Because of limited cash flow, we have had to wait to make some
13 improvements, but it is certainly a reasonable rate setting approach to allow a
14 known and measureable cost (we have a specific proposed for the new billing
15 system).

16 With respect to outside services for engineering, Ms. Stutz rejects DIUC
17 use of five-year average because it is not typically mode for normal test year
18 expense items and allows the test year expense. I disagree, in my experience, the
19 typical way to normalize expenses that fluctuate significantly from year to year is
20 to use an average. We also obtained invoices from the engineering firm for the
21 \$5,584 that Ms. Stutz eliminated as being undocumented, for work with respect to
22 the preparation of consumer confidence reports.

23

1 **Q. Do you agree with the Dr. Carlisle's recommendation with respect to the rate**
2 **return on equity?**

3 A. While the DCF and CEM analysis by Dr. Carlisle may be appropriate for the large
4 water utilities, they simply do not take into account the realities of a small water
5 and wastewater utility. For example, Ms. Stutz proposes adjustments for wages,
6 insurance, engineering costs, a new billing system, and a variety of others. While
7 those disallowances are proposed for rate setting (with which we disagree), the
8 reality is that DIUC will be incurring these expenses. Accordingly, the actual
9 earnings DIUC would achieve in the year the new rates become effective if they
10 reflect acceptance of ORS's adjustments, would not be if Dr. Carlisle's
11 recommended level by a significant amount. Moreover, ORS has proposed rate
12 base adjustments for the cost of various facilities that are real and for facilities
13 that are used and useful in providing service. And furthermore, not a penny of the
14 capital improvements that both DIUC and ORS anticipates will begin to be
15 constructed in the first year the new rates become effective, are included in the
16 rate base to which Dr. Carlisle's rate of return is applied. Accordingly, rates
17 reflecting all of ORS's recommendations would in the first year, produce
18 significantly less actual earning and the actual net investment will be significantly
19 higher. The result would be an actual equity rate of return considerably less than
20 Dr. Carlisle's recommendation -- because the reality of small utility
21 characteristics is not taken into account in the DCF and CEM analyses.

1 **Q. Do you agree with the recommendation of both Dr. Carlisle and Mr. Morgan**
2 **with respect to request permission from the PSC before DIUC pays**
3 **dividends to its stockholders?**

4 A. No. There is no basis for such a recommendation and it could be counter-
5 productive. Since acquiring HPUC and MUC, CK Materials and DIUC have
6 provided adequate service to the customers, despite unanticipated such adverse
7 circumstances as a loss of 25 – 30% of annual revenues attributable to MUC’s
8 former owner, and a lack of records and prior management. The proposed rate
9 increase includes the conversion of a portion of equity into debt for the primary
10 reason that DIUC will be able to finance capital improvements -- as a way of
11 overcoming the dilemma in which capital improvements would not be included in
12 rate base until they are in service and potential investors will not lend money until
13 they are included in rate base. The imputation of debt is a known and measurable
14 change that reduces the revenue requirement because it has a lower cost rate than
15 equity and its interest is a tax deduction that reduces the allowed income taxes. If
16 ORS is concerned about the need to make capital improvements and wants
17 additional assurance beyond the stated purpose of the debt financing in DIUC’s
18 rate filing, DIUC would agree to a stated commitment in the PSC’s order to use
19 proceeds of the debt financing for capital improvements, assuming of course that
20 the rate increase is enough to enable the issuance of debt and cover accounts
21 payable and working capital needs.

22 The ORS recommendation that permission would be needed before paying
23 dividends conveys a negative connotation that may impact the ability to obtain a

1 loan, which would be counter-productive and not in the best interests of the
2 customers.

3 It is noted that dividends are paid out of retained earnings. In the
4 conversion of equity into debt, the proceeds of the debt financing will be recorded
5 as a credit to long term debt and debit to cash. The payment to CK Materials in
6 order for it to pay off its loan with Coastal States Bank would be a credit to cash
7 and debit to paid in capital. The use of cash, is essentially the use of equity to
8 cover DIUC operating costs. Any payments to CK Materials, if money is
9 available after paying capital improvements, would be a debit to paid in capital,
10 not a dividend payment.

11

12 **Q. Have you reviewed the issue of availability fees related to Oak Ridge and**
13 **Beach Field lots?**

14 A. When acquiring MUC, its billing records did not contain information about those
15 areas. We have compiled a list of owners of the lots in those areas and have
16 provided it to ORS. It appears that as many as some 100, plus or minus, may be
17 subject to availability charges. We will continue to determine the exact number
18 and, once known, we believe it would be appropriate to reflect additional
19 availability revenues -- as known and measurable even though the revenues have
20 not actually been received.

21

22 **Q. Do you have any comments regarding the testimonies of Mr. Lynn M. Lanier**
23 **and Ms. Ellen Blumenthal?**

1 A. Yes. Some of their proposed adjustments are similar to those of the ORS, which I
2 have previously addressed. With respect to rate case expenses, the amount
3 included in this rate filing are less than the amount allowed in the recent rate case
4 of Kiawah Island Utility, Inc. Docket No. 2011-317 WS, even though the process
5 required the same effort. The lower rate case expense is for the most part due to
6 the self-imposed limit of my firm's charges.

7 With respect to management fees, these witnesses provide no analysis
8 supporting their proposed reductions. They don't mention that adequate service
9 has been provided despite the loss of 25 – 30% of revenues, beyond control of
10 DIUC. They don't mention that DIUC essentially operated MUC without
11 compensation after the MUC's system was abandoned and without which service
12 would have been disrupted for an unknown period of time. Although referencing
13 the Kiawah Island Utility case for rate of return comparisons, they don't mention
14 that DIUC's proposed rates are about the same as those granted for Kiawah. They
15 don't discuss the reality that DIUC has less than 20% of the number of customers,
16 and the rates should be higher on a per customer basis. They don't mention that
17 the cost of operations on an island with no direct access except by boat is more
18 costly. And, they don't mention that the HPCCA entered into a settlement
19 agreement in the acquisition of HPUC by CK Materials requiring DIUC to retain
20 Guastella as the manager as a condition to approve the acquisition.

21 With respect to rate of return, Mr. Lanier, he recommends an overall rate
22 of return of 4.3%, with an equity rate of 2.86% that is less than 50% of the debt
23 rate of 5.75%. I have been involved in thousands of rate cases, I have never seen

1 a recommendation in which the cost of equity is less than the cost of debt--
2 beyond understanding.

3 In sum, if Ms. Blumenthal and Mr. Lanier's recommendations are
4 accepted, there would be no ability to attract capital for needed capital
5 improvements, and no ability to assure continued adequate service.

6 Finally, DIUC and MUC systems are functionally integrated as to billing,
7 accounting, operations, management, financing and administrative costs. Single
8 tariff pricing under which all customers pay the same rates for the same service is
9 the preferable rate structure.

10

11 **Q. Why do you preference your rebuttal testimony with these general**
12 **comments?**

13 A. I believe it is important for the PSC to understand how the change in ownership
14 and management of the former HPUC and MUC dealt with small utilities with
15 significant problems, absorbed a major loss of revenues and yet provided good
16 service to the customers, all with a degree of financial sacrifice of the
17 Stockholders, operators, management and vendors. This picture is not

18

19 **Q. Does this conclude your testimony at this time?**

20 A. Yes.